THE COURT'S INTERPRETATION OF THE CONCEPTS OF INDEBTEDNESS AND EQUITY IN CLOSELY HELD CORPORATIONS

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CHAPTER I

INTRODUCTION

The purpose of this study was to determine how the courts, between 1913 and the present time, have interpreted the concepts of corporate indebtedness and equity resulting from shareholder loans and investments. The problem was studied in relation to federal income taxation and is most common in closely held corporations.

In determining a taxpayer's federal income tax liability an adversary position exists between the taxpayer and the representative of the federal government responsible for the enforcement of federal income tax laws. Within a given legal framework, the taxpayer's objective is to minimize his federal income tax liability while the objective of the representative of the federal government is to maximize federal income tax revenues. The problem under review develops when a corporation and/or its stockholders attempt to gain certain tax advantages without incurring any other substantive disadvantages. The courts have been called upon to decide the issue when the taxpayer and the representative of the federal government have been unable to reach an agreement.

The first part of the thesis deals with the adversary position stated above and with certain specific code sections, included in the study, wherein the problem arises. The remainder of the thesis presents the historical development of the court's interpretation of the concepts of corporate indebtedness and equity resulting from shareholder loans and investments. The historical development was divided into three periods: (1) the period before 1946, (2) the period from 1946 to 1956, and (3) the period after 1956. Credit for the division points in the historical sequence is given to Mortimer Caplin.[1]

Data and information for the thesis were derived primarily from court decisions. The decisions were collected from the United States Board of Tax Appeals and its successor the United States Tax Court, United States Circuit Courts of Appeal, United States District Courts, and the United States Supreme Court. Other important sources of information were provided by the Federal Internal Revenue Code and the regulations and rulings of the Internal Revenue Service.

The purpose of the thesis was to:

1. To study factors and the weight given thereto by the courts in determining whether an instrument represented debt or equity.

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[1]Mortimer Caplin, "The Caloric Count of a Thin Incorporation," Proceedings of New York University (November 17, 1959), 774.

2. To ascertain whether there has been a shift in emphasis on various factors, by the courts, in a debt vs. equity determination, and

3. To present a conclusion which would provide useful guidelines to those in the federal income tax field who counsel corporate managers concerning the tax impact of a proposed "thin corporation".

CHAPTER II

ADVERSARY POSITION OF PARTIES TO COURT ACTION

A taxpayer with the objective of minimizing his federal income tax liability is, in effect, an adversary of the Commissioner of Internal Revenue whose objective is to maximize the amount of federal income tax revenues collected. The stockholder of a closely held corporation operates in a dual capacity. He is both an individual taxpayer and a vested interest party in the affairs of the corporation as a taxpayer. To simplify the discussion of stockholder-individual taxpayer interests it is assumed for purposes of this chapter, unless otherwise specified, that the stockholder being discussed owns 100 per cent of the stock of a closely held corporation.

The stockholder will consider his individual interests and corporate interests in combination. A corporate financial structure that will cause the corporate tax liability to be decreased by an amount greater than the increase in his individual tax liability will be chosen by the stockholder. Assume the stockholder, in addition to his stock investment, loans property to the corporation in which he is the sole stockholder. The corporation can pay interest on the loan and deduct the amount of interest expense from the corporation income tax return and a lower corporation income tax liability will be the result. Assume instead that the stockholder invests additional property in the corporation in which he is the sole stockholder. The corporation may pay dividends on the additional stock investment, but the amount of dividends cannot be deducted from income. The stockholder, on his individual tax return, must recognize either the interest or dividends received as income. Receipt of dividend income by an individual taxpayer is usually given slight preferential tax treatment as opposed to the receipt of interest income by the same individual taxpayer.

The loan of property to a corporation by the stockholder may be advantageous if the corporation goes bankrupt. A worthless loan may be deducted, by the stockholder, on his individual tax return as a bad debt. The issue of corporate indebtedness resulting from shareholder loans has arisen in connection with several provisions of the Internal Revenue Code. The cases reviewed in this study will be limited to the provisions for an interest deduction by a corporate taxpayer, a bad debt deduction by an individual taxpayer, and the inclusion of indebtedness in invested capital under an earlier law. Excluded from this study are any cases involving the tax-free withdrawal of investment by stockholders, the significance of debt in connection with excess accumulation of corporate income, the significance of debt in relation to nontaxable transfers solely in exchange for stock or securities and exchange of stock for debt under a tax-free recapitalization.

The interest deduction by the corporate taxpayer and the bad debt deduction by the individual taxpayer have been discussed briefly above. A historical review of these provisions was not presented in this thesis. The brief explanation of these provisions is to indicate advantages the taxpayer may seek and why an adversary proceeding arises. Corporate indebtedness resulting from shareholder loans can give these advantages to a shareholder.

The final provision of the law under review needs clarification. In some of the early cases presented in this study it was advantageous for a corporate taxpayer to assert that debt securities represented "invested capital". This issue arose because of a War-Profits and Excess Profits Tax Law. Under this law an additional tax was imposed on corporate income exceeding a certain level of invested capital. The Revenue Act of 1918 expressly excludes borrowed capital in defining invested capital. Under that Act borrowed capital meant, "money or other property borrowed, whether represented by bonds, notes, open accounts, or otherwise."[1] This clarification is important because the adversary positions of the taxpayer and the Commissioner of Internal

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[1] United States Congress, Statutes, 65th Congress, Vol. XL, Part I, P.L. 254, Sec. 325 (Washington: Government Printing Office, 1919), p. 1091.

Revenue were exactly opposite from the adversary positions, in the majority of cases, where the corporate interest deduction or a bad debt deduction by an individual were at issue.

This brief chapter explains the adversary position of the parties involved in court proceedings. Subsequent chapters will deal directly with the interpretation the courts have given to the concepts of corporate indebtedness and equity resulting from shareholder loans and investments.

CHAPTER III

PERIOD FROM 1913 TO 1946

This chapter presents a review of court cases between 1913 and 1946. The period has been referred to as the "hybrid security era".[1] This designation is derived because many of the securities reviewed by the courts had features common to both debt and equity instruments. In commenting on hybrid securities Mr. Uhlman states:

> While the parties sometimes thus create securities which might be called bond as well as shares of stock, it is the province of the courts to draw the line of demarcation between creditor and enterpriser securities. Although in a given case the bond and stock features of an instrument seem to be hopelessly interwoven, the courts are called upon to untangle them and decide whether in the last analysis the bond or the stock character of the instrument prevails. For in the eyes of the law there are no hybrid securities. In the law a person is either a creditor or a stockholder, he cannot be both.[2]

The courts in determining the character of a security considered certain evidential factors. The factors the courts developed will be studied in turn.

The courts were confronted with the basic proposition that the owner of a corporate security had to be either a

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[1] Caplin, supra at 2, at 775.

[2] Rudolph E. Uhlman, "The Law of Hybrid Securities," 23 Washington University Law Quarterly, 182, 184 (1938).

creditor or a stockholder. This point was referred to in the Appeal of I. Unterberg & Company wherein it was stated, "as counsel for the taxpayer says, they cannot be both stock and notes."[1] The court opinions provided no comprehensive rule by which cases could be decided. In The Proctor Shop, Incorporated case the Board of Tax Appeals stated:

> None of the decided cases lay down any comprehensive rule by which the question presented may be decided in all cases, and the decision in each case turns upon the facts of that case.[2]

The courts considered all of the evidence presented and the real character of the instrument was determined by the court's examination of its terms and related circumstances.

The name given to an instrument as well as the consistency of using the name in the company records was considered by the courts in all cases. This is illustrated in the I. Unterberg & Company case when it was stated:

> In the corporation's opening journal entry it is called a debenture note, on the face of the instrument it is called a note, it bears the documentary internal revenue stamps proper for a note, and in the stockholder's agreement it is called a debenture note.[3]

There was a strong presumption that an instrument was what it was called. This was brought out by the court in the Appeal

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[1] Appeal of I. Unterberg & Company, 2 B.T.A. 274, 280 (1925).

[2] The Proctor Shop, Incorporated, 30 B.T.A. 721, 725 (1934).

[3] Appeal of I. Unterberg & Company, 2 B.T.A. 274, 279 (1925).

of A. H. Stange Company when it was stated:

> The presumption that instruments made in the form and language of debenture notes and issued by a newly organized corporation to the subscribers for its capital stock, and in an amount which, together with its authorized stock issue, equals the value of the properties turned over to the corporation at the instance of its organizers, represent borrowed capital, can be overcome, if at all, only by convincing evidence.[1]

The court made it clear in the Appeal of Leasehold Realty Company that material evidence would be required to overcome the presumption when it stated, "there is in this particular case no material evidence that this instrument is not what it purports to be on its face."[2] In the Appeal of Kentucky River Coal Corporation the name of the instrument was the first factor considered and the court stated, "the name of the instrument is not a thing to be ignored, for it is not lightly to be assumed that parties have given an erroneous name to their transaction."[3] In the Leasehold Realty Company case the court stated, "the name given to the instrument is not conclusive of its character and inquiry will be made as to its real character."[4] This point was further emphasized in the opinion of the H. R. DeMilt Company case when it was stated:

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[1] Appeal of A. H. Stange Company, 1 B.T.A. 58 (1924).

[2] Appeal of Leasehold Realty Company, 3 B.T.A. 1129, 1131 (1926).

[3] Appeal of Kentucky River Coal Corporation, 3 B.T.A. 644, 649 (1926).

[4] Appeal of Leasehold Realty Company, 3 B.T.A. 1129 (1926).

> The final determination must be made upon a legal interpretation of the meaning of the entire instrument and not upon the name by which it was denominated.[1]

The name of an instrument was one of several factors considered by the courts in determining its real character. The real character of an instrument was determined from the intent of the parties involved in the court action. In the cases thus far cited the court held that instruments named debenture notes and income debentures represented indebtedness and held that instruments named debenture stock and preferred stock represented equity.

An interesting contrast was in the Proctor Shop case where the instrument was named debenture preference stock. In this case the father of the company president was willing to loan money to the company but was not willing to invest in capital stock. So that the corporation's credit status would not be impaired, debenture preference stock was issued to him which was redeemed at a minimum of $1,500 per month with 6 per cent cumulative interest. In this case the court held that the instrument represented indebtedness.[2]

The presence or absence of a fixed maturity date in an instrument has been considered by the courts as an important factor in determining the intent of the parties. In the

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[1] H. R. DeMilt Company, 7 B.T.A. 7, 9 (1927).

[2] The Proctor Shop, Incorporated, 30 B.T.A. 721 (1934) aff'd, 82 F. 2d 792 (9th Cir. 1936).

H. R. DeMilt Company case the court stated, "we consider it significant that the instrument speaks of the principal as becoming due and payable on a particular date, though subject to payment at a prior date."[1] The court indicated that such terminology was more consistent with a loan than a capital stock arrangement. The Commissioner v. O.P.P. Holding Corporation involved securities which were subordinated, both as to principal and interest, to the claims of all other creditors and the payment of interest could be suspended, though not beyond the fixed time when the principal was payable.[2] The court stressed the fixed maturity date and held that the instruments were in fact bonds. The instruments were held to be bonds in spite of the fact that the corporation had the option to redeem the bonds before the fixed maturity date and that the maturity date for the issue could be extended by a two-thirds majority vote of the bondholders. In Commissioner v. Schmoll Fils Associated, Inc., the same tribunal again stressed the factor where the instruments did not have a fixed maturity date. The interest could be paid only from net profits and the debentures were subordinated to bank creditors. In the opinion of the case the court stated:

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[1] H. R. DeMilt Company, 7 B.T.A. 7, 11 (1927).

[2] Commissioner v. O.P.P. Holding Corporation, 76 F. 2d, 11 (2d Cir. 1935), affirming 30 B.T.A. 337 (1934).

> It is not necessary to hold that the absence of a maturity date if taken alone would prevent a document from representing an indebtedness or would invariably preclude the return from investments evidenced by the debentures from being treated as interest.[1]

The court held that the alleged debentures represented equity. In the Leasehold Realty Company case the court pointed out that a definite maturity date was not a characteristic uncommon to preferred stock.[2] This indicates that a fixed maturity date is not conclusive evidence that indebtedness has been created.

During this period the courts considered a fixed maturity date an important factor indicating that an instrument represented indebtedness, but the existence of a fixed maturity date alone was not conclusive evidence that a debtor-creditor relationship had been created.

Certainty that the principal will be repaid has been considered by the courts as an important factor in determining whether an instrument represented indebtedness or equity. In the I. Unterberg & Company case the taxpayer contended that the instrument represented an equity interest. The debentures note under review promised to pay a certain sum to a definite person at a definite time, but the rights of the holder were subordinated to those of general creditors. The taxpayer's

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[1] Commissioner v. Schmoll Fils Associated, Inc., 110 F. 2d, 611, 614 (2d Cir. 1940).

[2] Appeal of Leasehold Realty Company, supra at 10.

contention that the instruments represented risk capital was based on the fact the debenture notes were subordinated to indebtedness held by general creditors. The court in holding that the condition of subordination alone did not warrant an equity determination when all the other factors indicated that the instruments were indebtedness, stated, "in other words, the dominant feature is said to be the condition and the risk and not the promise to pay".[1] The debenture preference stock, in the Proctor Shop, Incorporated case, was also subordinated to general creditors. The corporation was obligated to repay principal monthly at a fixed rate and nonpayment of interest for a two-year period rendered the corporation in default. Upon default by the corporation certificate holders had the right to institute action to collect the principal amount of the certificates plus accumulated interest.[2] Subordination of stockholder held indebtedness to the claims of other creditors usually indicates that stockholder held indebtedness represents an equity interest. The subordination factor is only one of many factors considered by the courts, and as cited above, this factor alone may not prove that a stockholding interest existed.

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[1] Appeal of I. Unterberg & Company, 2 B.T.A. 274, 279 (1925).

[2] The Proctor Shop, Incorporated, supra at 11.

A provision giving the stockholder-creditor the right to unconditionally demand repayment of principal at a specified time was considered by the courts as a factor indicating instruments represented indebtedness. In Jewel Tea Company v. United States repayment of principal could be demanded only in the event the company was liquidated. Some of the securities had been retired, but retirement of the securities was at the discretion of common stockholders and was dependent on accumulated corporate earnings. The court in holding that the instruments under review did not represent indebtedness stated:

> Possibly Commissioner v. O.P.P. Holding Corporation does not commit us to the doctrine that shares must under all circumstances be debts when they contain a provision that the holder may unconditionally demand his money at a fixed time. All we now decide is that in the absence of such a provision the security cannot be a debt.[1]

The instrument under review, in Leasehold Realty Company provided that the company would not convey or encumber a certain leasehold without the consent of the instrument holders or incur indebtedness in excess of $1,500 after a certain building was constructed. The holders of the instruments had the right to require liquidation of the company if there was a default on either of these provisions. The court indicated that these characteristics were not

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[1] Jewel Tea Company v. United States, 90 F. 2d, 451, 453 (2d Cir. 1937).

uncommon to preferred stock and held that the instruments in question represented equity interests.[1]

The certainty that principal will be repaid has been considered by the courts as an important factor indicating that instruments do represent indebtedness. In all the cases studied a definite obligation to pay a fixed sum has existed if the instruments have been held by the courts to represent indebtedness. The court clearly stated in O.P.P. Holding Corporation case that the "final criterion between creditor and shareholder we believe to be the contingency of payment."[2] The right of security holders to enforce payment of principal upon default, the intent to do so, absence of subordination clauses and having the debt secured have been indicated by the courts as favorable factors indicating that instruments represent indebtedness.

The payment of interest on indebtedness is an usual provision of an indebtedness agreement and the courts have examined each security to ascertain whether it provides with certainty that interest will be paid to the stockholder-creditor. In several cases the return on alleged indebtedness was to be paid from the net profit of the corporation. In the Schmoll Fils Associated case the court stated:

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[1] Appeal of Leasehold Realty Company, supra at 10.

[2] Commissioner v. O. P.P. Holding Corporation, supra at 12, 76 F 2d at 12.

> But here the absence of a maturity date, the obligation to pay income from net earnings and the subordination of the debentures to the rights of bank creditors render the payments more like dividends than interest and the securities like preferred stock rather than bonds.[1]

In the Jewel Tea Company case payment of interest on the securities could be required only out of corporate profits. The court held, as cited earlier, that the alleged indebtedness represented equity.[2] In the H. R. DeMilt Company case the court did not give much weight to the fact that interest was to be paid out of surplus or net profits and stated:

> We are concerned here with the principal itself, which is an enforcible lien against the assets of the corporation and which is subject to repayment in twenty years.[3]

In this case the court minimized the fact that interest was payable only from earnings and emphasized the fixed maturity date and the certainty that principal would be repaid. In Finance & Investment Corporation v. Commissioner instruments were held to represent equity interests. In the opinion of the case the court stated:

> This conclusion follows from the fact that they were not entitled to demand a fixed rate of return upon their investment, but only such dividends not

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[1] Commissioner v. Schmoll Fils Associated, Inc., 110 F. 2d 611, 614 (2d Cir. 1940).

[2] Jewell Tea Company, Inc., v. United States, 90 F. 2d 451 (2d Cir. 1937).

[3] H. R. DeMilt Company, 7 B.T.A. 7, 11 (1927).

> exceeding eight per cent per annum as were payable from the net earnings of the company.[1]

The court indicated that the payment of interest should be unconditional for a definitely ascertainable sum and with a fixed rate of interest. The presence of these three features in a security tend to indicate that the instruments represent indebtedness. In the O. P. P. Holding Corporation case payment of interest and principal was subordinate to the claims of all other creditors, the interest was at a fixed rate and cumulative, but the payment of interest could be deferred by the company. Even though the payment of interest could be suspended, at the option of the company, the obligation to pay interest at a future time existed. The court commented on this point when it stated, "the fact that ultimately he must be paid a definite sum at a fixed time marks his relationship to the corporation as that of a creditor rather than shareholder."[2] The court held that the debentures did represent indebtedness.

In First Mortgage Corporation of Philadelphia v. Commissioner the court stated:

> A fixed rate of interest payable in the absence of profits is a normal characteristic of a debt. Although the rate of dividends upon the petitioner's preferred

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[1] Finance & Investment Corporation v. Commissioner, 57 F. 2d, 444, 445 (D.C. Cir. 1932).

[2] Commissioner v. O.P.P. Holding Corporation, supra at 12, 76 F. 2d at 12.

> stock is fixed, payment of the dividends may be made only if and when declared by the petitioner's board of directors.[1]

The court held that the obligations represented preferred stock rather than indebtedness. The right of security holders to enforce payment of interest on default, an unconditional promise to pay a definitely ascertainable amount of interest, a fixed interest rate and the payment of interest even though there were no corporate earnings have been indicated by the courts as favorable factors indicating that instruments represent indebtedness. The certainty that interest will be paid on a security was considered by the courts to be an important, but not conclusive, factor indicating debt in an indebtedness-equity determination.

The right of security holders to vote has been viewed by the courts as a characteristic associated with an equity interest. Since it is not uncommon for preferred shareholders to be excluded from voting rights, this factor has been given limited weight by the courts. The courts have also varied in the conclusions that have been reached relative to the characteristic of voting rights. In the Schmoll Fils Associated, Inc. case the court stated, "while the debenture holders have no vote at meetings of the company, preferred stockholders sometimes have no such right."[2] The three main

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[1] First Mortgage Corporation of Philadelphia v. Commissioner 135 F. 2d, 121, 124 (3rd Cir. 1943).

[2] Commissioner v. Schmoll Fils Associated, Inc., 110 F. 2d 611, 613 (2d Cir. 1940).

factors in the case considered by the court were the absence of a maturity date, the subordination agreement and the obligation to pay interest from net earnings. The court seemed to minimize the fact that security holders did not have the right to vote. The court held that the instruments represented an equity interest.

In the Kentucky River Coal Corporation case the holders of securities had no right to vote unless the corporation was in default on the payment of dividends on the securities. The court held that the securities represented stock, but the fact that security holders could not vote seemed to be given very little weight.[1]

The courts discussed voting rights in the above two cases and in one subsequent case[2] presented in this chapter. It would appear that the courts considered the presence of voting rights indicative of a stockholding interest and the absence of voting rights indicative of a creditor interest. The courts did not place much emphasis on the factor of voting rights during this period.

As discussed above, the courts considered a fixed rate of return on a security to be indicative of indebtedness. Conversely the right of a security holder to share in the

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[1] Appeal of Kentucky River Coal Corporation, 3 B.T.A. 644 (1926).

[2] Parisian, Inc., v. Commissioner, 131 F. 2d 394 (5th Cir. 1942).

vprofits beyond a fixed rate of return has been considered by the courts to evidence an equity interest.

In Haffenreffer Brewing Company v. Commissioner shareholders were entitled to share equally in earnings with the common shareholders after each had received certain specified dividends. The court emphasized the sharing in profits beyond a fixed rate of return and the absence of a fixed maturity date in holding that the securities represented a capital investment.[1] The issue of sharing in the profits beyond a fixed rate was considered by a court, during this period, only in the above case. The right of a security holder to share in profits beyond a fixed rate was viewed by the court as a feature indicative of a stockholding interest.

A bona fide business purpose for a corporation issuing indebtedness was considered by the courts as a factor indicating the instruments represented indebtedness. In Proctor Shop, Inc. debenture preference stock was issued so the corporation's credit status would not be impaired. In commenting on the factor of business purpose the court stated:

> Here there was no usurious contract to be avoided, but there was a reason personal to the parties concerned, namely, that Aaron Holtz was unwilling to become an investor in the corporation to be formed, but was willing to lend it money, and the transaction

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[1] Haffenreffer Brewing Company v. Commissioner, 116 F. 2d, 465 (1st Cir. 1940), cert. denied, 313 U.S. 567 (1941), affirming 41 B.T.A. 443 (1940).

> was placed in that form so as to preserve the corporation's credit.[1]

The court held that the instruments represented indebtedness.

Ordinarily the substitution of stock for debt would be a factor indicating that the stock represents an equity interest. This was not so in the Brush-Moore Newspapers, Inc. case in which preferred stock was substituted for indebtedness. The substitution of stock for debt resulted because the company was in financial trouble and desired to delay the installment payments due on the principal of the indebtedness. It was agreed that a fixed amount would be paid as interest if dividends on the preferred stock were not paid. When dividends were paid on the remainder of preferred shares held by others, the interest paid on stock substituted for debt was to be offset against dividends applicable to this stock. As a guarantee for the payment and redemption of the stock, principal and dividends, certain insurance policies were deposited with a trustee. The substitution of the stock for debt in effect postponed the payment of principal indefinitely. The court held that the preferred shares under review represented indebtedness.[2]

In two other cases the court found no business purpose for the substitution of stock for debt and held in both cases that the stock represented an equity interest. In Angelus

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[1] Commissioner v. Proctor Shop, Inc., 82 F. 2d, 792, 795 (9th Cir. 1936).

[2] The Brush-Moore Newspapers, Inc., 37 B.T.A. 787 (1938).

Building & Investment Company v. Commissioner one of the stockholders testifying on the substitution of stock for debt said, "we wanted to get it in more convenient form, and we also wanted something behind that account."[1] In holding that the stock represented an equity interest the court stated, "a taxpayer cannot by a form of book entry, merely change the amount of an income total."[2] In United States v. South Georgia Ry. Company stock was substituted for debt and the stockholders in a board resolution provided that the stock should constitute a lien on the assets of the corporation. This provision was not included in the stock certificates and in the court's opinion it was not included because it was not permissible under state law to secure the stock by a lien. The stock had been issued by the corporation as part of a general rearrangement of its capital structure to pay off its bonded debt. The court held that the stock represented an equity interest.[3]

The court in Arthur P. Jones Syndicate v. Commissioner viewed the circumventing of a state usury law as a business purpose for issuing securities as preferred stock even though the true nature of the instruments was indebtedness. In

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[1] Angelus Building & Investment Company v. Commissioner, 57 F. 2d, 130, 131 (9th Cir. 1932). cert. denied, 286 U.S. 562 (1932), affirming 20 B.T.A. 667 (1930).

[2] Ibid at 131.

[3] United States v. South Georgia Ry. Company, 107 F. 2d, 3 (5th Cir. 1939).

discussing business purpose the court commented:

> A taxpayer who borrows money at a usurious rate of interest and who, to conceal the usury, is compelled to execute a document which does not correctly describe the relationship of the parties, may, as against the government, disclose the true relationship of debtor and creditor.[1]

The court held the preferred shares represented indebtedness.

Business purposes for transactions can be many and varied. The cases discussed above serve as examples of a business purpose, or the lack of a business purpose for a transaction. As has been mentioned above, the courts considered a bona fide business purpose for a transaction as a factor indicating indebtedness. Conversely the absence of a business purpose was at times considered a negative factor indicating a stockholding interest.

During this period the courts considered the intent of the parties responsible for issuing a particular instrument significant. Each of the factors discussed above have been considered by the courts in determining the intent of the parties to a transaction. In addition to these factors evidence outside of the contract was admissible. In a case previously cited preferred stock was issued to circumvent state usury laws and the court said, "but the better reasoning sustains the view that a borrower whose necessities lead him to the door of a usurer may always show, by evidence aliunde

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[1] Arthur P. Jones Syndicate v. Commissioner, 23 F. 2d, 833, 835 (7th Cir. 1927).

the contract, the real character of the transaction."[1] As has been mentioned earlier, the court held that the securities represented indebtedness. The Brush-Moore Newspapers case[2] and the Proctor Shop, Inc. case[3] are other good examples of the use of evidence aliunde the contract to establish the intent of the parties to a transaction.

Some cases during this period emphasize the intent is important but do not elaborate on the issue as in the Appeal of I. Unterberg & Company.[4]

In Parisian, Inc. the court in discussing intent stated:

> The treating of instruments as shares of stock and periodical payments thereon as dividends by the corporation, prior to the year in question, was evidence of intent indicating a stockholding relationship.[5]

The issue of treating securities as shares of stock was discussed by the court in the South Georgia Ry. Company case.[6] There were other cases in which "intent" per se was not discussed.

It is pointed out by Mr. Caplin that the intent of the parties was the primary issue considered by the courts during

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[1] Id. at 834.

[2] The Brush-Moore Newspapers, Inc., supra at 21.

[3] Commissioner v. Proctor Shop, Inc., 82 F. 2d 792 (9th Cir. 1936).

[4] Appeal of I. Unterberg & Company, 2 B.T.A. 274 (1925).

[5] Parisian, Inc., v. Commissioner, supra at 20, 131 F. 2d at 395).

[6] United States v. South Georgia Ry. Compahy, supra at 22.

this period and that:

> Ultimately all the corporation had to prove was that it intended to issue a debt security and this might be possible even though the instrument bore the telling label of preferred stock.[1]

The concept of intent was considered by the courts to be very important during this period. The courts determined the intent of the parties by reference to the terms and conditions of the instrument and evidence outside of the contract. Even though the "real character"[2] of an instrument was to be determined, the courts seemed to be dealing with the subjective intent of the parties to a transaction.

In the opinion of the John Kelley Company case, which will be reviewed in the next chapter, reference was made to court decisions of the period under review when it was stated:

> The determining factors are usually listed as the names given to the certificates, the presence or absence of maturity date, the source of the payments, the rights to enforce the payment of principal and interest, participation in management, status equal to or inferior to that of regular corporate creditors, and intent of the parties.[3]

The above factors were considered by the courts as the important factors in determining whether a corporate security represented indebtedness or equity. One factor was omitted in the quotation, namely, the right of the

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[1] Caplin, supra at 2, at 776.

[2] Appeal of Leasehold Realty Company, supra at 10.

[3] John Kelley Company, 1 T.C. 457, 462 (1943).

security holders to share in profits beyond a fixed rate of return. This factor and the right of security holders to vote seemed to be of minor importance to the courts during this period. Practically none of the court cases were clear cut. The court decisions sometimes gave great weight to one factor with little emphasis on other factors.

The courts in determining intent of the parties relied mainly on the name given the instrument, the presence of a fixed maturity date for principal repayment, the certainty that principal would be repaid, the certainty that interest would be paid, business purpose as opposed to strictly tax avoidance and evidence outside of the contract.

CHAPTER IV

PERIOD FROM 1946 TO 1956

This period has been referred to as the "age of ratios".[1] In the ratio referred to debt was the numerator and equity the denominator. The common method of determining the ratio was to compare the face amount of indebtedness held by stockholders to the fair market value of the net assets of the corporation. The fair market value of net assets included goodwill, unrealized appreciation of assets and other intangibles not recorded in the accounting records as well as the fair market value of equity recorded in the books.[2] In certain cases debt held by other creditors was included in indebtedness for purposes of computing the ratio. This was illustrated by the <u>Isidor Dobkin</u> case.[3] In that case Dobkin and three associates each advanced $7,000 to Huguenot Estates, Inc. and in each instance $500 was designated equity and $6,500 as indebtedness. The corporate property was encumbered by first and second mortgages totaling $44,000. The indebtedness to stockholders of $26,000 was added to the amounts advanced by other lenders of $44,000, a total

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[1] <u>Caplin</u>, <u>supra</u> at 2, at 777.

[2] <u>Millers Estate</u> <u>v</u>. <u>Commissioner</u>, 239 F. 2d, 729 (9th Cir. 1956).

[3] <u>Isidor Dobkin</u>, 15 T.C. 31, 33 (1950).

indebtedness of approximately $70,000. The indebtedness of $70,000 was compared to the equity of $2,000, a debt-equity ratio of 35 to 1.

In this chapter the use and application of the debt-equity ratio by the courts was reviewed. Factors reviewed in the preceding chapter were also used by the courts during this period and new development of these factors was shown as they appeared in cases. The debt-equity ratio represented a new criterion used by the courts and its emphasis in this chapter was justified by the great weight it was given by the courts.

The concept of the debt-equity ratio had its genesis in the dictum of John Kelley Company v. Commissioner, when Mr. Justice Reed stated in the Supreme Court opinion:

> As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure.[1]

Even though the court did not find it necessary to use the debt-equity ratio test in the John Kelley Company case, a standard had been promulgated which was used repeatedly by the courts during this period. In the past courts had relied on the terms and conditions of the instrument, as well as evidence aliunde, to determine the intent of the parties. In many instances a case turned on one or several factors which

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[1] John Kelley Company v. Commissioner, 326 U.S. 521, 526 (1946), reversing 146 F. 2d 466 (7th Cir. 1944), reversing 1 T.C. 457 (1943).

were afforded great weight by the courts, to the exclusion of other factors. The process of comparing and weighing factors lacked objectivity. The ratio test offered an apparent quality of objectivity.

Courts considering the debt-equity issue in this period were required to determine what represented a "nominal stock investment" and an "obviously excessive debt structure". The usual meaning of nominal is something so small and insignificant that it is scarcely entitled to bear the name thereof. Excessive, as customarily used, is something exceeding that which is usual, normal, and reasonable. These meanings provide little in explaining what the court in the John Kelley Company case meant and only help in designating the problem that future courts would face in interpreting the terms. Cases of this period were reviewed to determine the interpretation given these terms and the application thereof by the courts.

The review will begin with a more detailed examination of the John Kelley Company case,[1] and Talbot Mills v. Commissioner[2] which were reviewed together by the Supreme Court. In the John Kelley Company case the Tax Court held that the securities in question represented indebtedness. The Tax

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[1] Ibid.

[2] Talbot Mills v. Commissioner, 326 U.S. 521 (1946), affirming 146 F. 2d 809 (1st Cir. 1944), affirming 3 T.C. 95 (1944).

Court decision was reversed by the Circuit Court of Appeals, but was upheld by the Supreme Court. In the Talbot Mills case the Tax Court ruled that the securities in question represented equity and the decision was affirmed by the Circuit Court of Appeals and the Supreme Court.

In the John Kelley Company case the debt-equity ratio was approximately .2 to 1, while in the Talbot Mills case the debt-equity ratio was 4 to 1. The debt-equity ratio in the latter case has been referred to as 4 to 1[1], but book value instead of the fair market value of net assets was used in computing the debt-equity ratio. The debt-equity ratio in the former case was computed by the writer on the basis of book value. It would have been a coincidence if the debt-equity ratio using book value of net assets and fair market value of net assets respectively as the denominators produced the same results, but "a belief developed that a 4:1 debt-equity ratio would clearly be safe."[2] Since in the Talbot Mills case Mr. Justice Reed did not consider debt of $400,000 excessive nor did he consider equity of $100,000 nominal, it followed that taxpayers might view the 4:1 debt-equity ratio as a conservative guideline.

The factors present in the Talbot Mills case which distinguished it from the John Kelley Company case were a

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[1] Caplin, supra at 2, at 783.

[2] Ibid.

variable annual return on the securities with a minimum rate of two per cent and the fact that issuance of the securities was limited to stockholders who exchanged stock for the purported indebtedness. The similarity of characteristics of the two securities is striking. In the John Kelley Company case the securities were named income debentures, had a fixed maturity date 20 years hence, were subordinated to claims of all creditors with a collection procedure for certain designated defaults, paid an 8 per cent noncumulative rate of return strictly from earnings, had no voting rights, and did not share in profits beyond the fixed rate. In the Talbot Mills case the securities were called registered notes, had a fixed maturity date 25 years hence, were subject to subordination to and in fact were subordinated to claims of outside creditors, had certain restrictions on the right of the corporation to mortgage real assets, paid a variable rate of return from 2 per cent to 10 per cent computed with reference to earnings, interest was cumulative but could be deferred, had no voting rights, and did not share in profits beyond the computed variable rate. There were recapitalizations in both cases. The Tax Court, in the Talbot Mills case, seemed to stress the lack of any business purpose for the recapitalization and conversely the motive of tax avoidance by the parties to the transaction. Judge Turner in presenting the opinion of the Tax Court, in the John Kelley Company case, was much more liberal on the factor of business purpose as he stated:

> It is apparent that the holders of the preferred stock in exchanging the stock for "20 year 8 per cent income debentures" preferred the debt or-creditor status of debenture holders to that of stockholders, and stockholders have the right to change to the creditor-debtor basis, though the reason may be purely personal to the parties concerned.[1]

The Supreme Court did not comment on business purpose or tax avoidance in reviewing the cases. The facts in both cases were very similar and in one case the securities were held to represent debt and in the other case equity. Subsequent court cases were reviewed to ascertain whether the debt-equity ratio was a reliable and safe criterion to follow.

The Isidor Dobkin case involved a debt-equity ratio of 35:1 including debt to oursiders and a 13.5:1 considering only stockholder debt. The Tax Court referred to the debt-equity ratio as 35:1 and held that stockholder debt represented equity. The capital stock of $2,000 was considered nominal and debt of $70,000 was considered excessive. The amounts advanced by stockholders and designated as debt were in direct proportion to their stockholdings which was a factor the court felt indicated that advances were equity.[2]

An extremely high debt-equity ratio of 1,250:1 was present in the Swoby Corporation case. The corporation

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[1] John Kelley Company, 1 T.C. 457, 462 (1943).

[2] Isidor Dobkin, 15 T.C. 31 (1950), affirmed per curiam 192 F. 2d 392 (2d Cir. 1951).

issued an income debenture of $250,000 and capital stock of $200 to a sole stockholder in exchange for property that had a fair market value of at least $250,200. The Tax Court relied heavily on the Supreme Court decision in the John Kelley Company case and decided that $250,000 of indebtedness was obviously excessive and $200 of capital stock was nominal. The income debenture had a definite 99 year maturity date, and the court indicated that a maturity 99 years hence was not in the reasonable future. The securities were unsecured, subordinate to claims of all creditors, payment of interest depended on corporate earnings and were collectible by the holder, if at all, only on dissolution. The Tax Court held that the purported indebtedness represented equity.[1]

In Alfred R. Bachrach petitioner advanced $2,667.71 to the Est Realty Company, Inc., $200 designated as capital stock and $2,467.71 recorded in the books as loans payable on open account. Among his three associates an additional $13,338.56 was advanced, $1,000 designated as capital stock and $12,338.56 designated as loans payable. The proportion of debt to equity was the same for each stockholder. The debt-equity ratio was 12 to 1. In this case no note was given, no interest was paid and there was not a fixed maturity date. It was emphasized that the capital contribution was so

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[1] Swoby Corporation, 9 T.C., 887 (1947).

nominal that it was inadequate for funding the purchase of property necessary to begin business operations. The Tax Court held that the purported indebtedness was a capital contribution and very specifically indicated that the corporation was undercapitalized.[1]

Mullin Building Corporation involved the transfer of certain real property by a family to a newly organized corporation in exchange for capital stock. Capital stock of $300,000 was issued to the family, $10,000 designated as common stock and $290,000 designated as debenture preferred stock. The taxpayer contended that the debenture preferred stock was indebtedness. The debt-equity ratio was 29:1. The securities had no fixed maturity date, were unsecured, had a lower priority than other indebtedness, had a very limited collection procedure in the event of default, paid 5 per cent cumulative interest, had no voting rights, and did not share in earnings beyond the fixed rate. The Tax Court found the latter point was more illusory than real since all earnings came from the rental of the one main asset, the building, and any payments to stockholders had to come from corporate earnings. A major portion of the building was rented to another family corporation in the clothing business. The instruments contained no provision for the enforcement of

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[1] Alfred R. Bachrach, 18 T.C., 479 (1952), affirmed per curiam 167 F, 2d 1001 (3rd Cir. 1948).

principal payments. The court felt the shareholders did not desire to enforce payment of principal. The Tax Court held that the securities represented equity.[1]

In Erard A. Matthiessen a corporation with a debt-equity ratio of 6:1 was considered by the Tax Court to be undercapitalized. Funds advanced by stockholders and designated as indebtedness totaled $76,983 together with capital stock of $12,000. The fact that the notes were unsecured and the inadequate capitalization of the corporation were the key factors the court considered in holding that the alleged indebtedness represented risk capital.[2]

In each of the five preceding cases securities designated as indebtedness were held to be equity. The factor of a high debt-equity ratio was certainly not the only factor relevant to the issue, but was definitely considered as an important factor. The corporations in these five cases were undercapitalized at the time the corporation was organized which is in contrast to the John Kelly Company and Talbot Mills cases which involved recapitalizations. Ordinarily stockholders invest the funds necessary to finance the purchase of assets necessary to operate the business. This usually includes working capital, organizational costs, and a substantial portion of the fixed assets. In many cases

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[1] Mullin Building Corporation, 9 T.C., 350 (1947) affirmed per curiam 167 F. 2d 1001 (3rd Cir. 1948).

[2] Erard A. Matthiessen, 16 T.C., 781 (1951), affirmed 194 F. 2d 659 (2d Cir. 1952).

if land and plant are purchased these assets may be mortgaged with funds provided by lenders. It is important to note that stockholder investments usually provide the risk capital which gives a buffer of protection to creditors. This fact was noted in the opinion of Isidor Dobkin when the court stated:

> When the organizers of a new enterprise arbitrarily designate as loans the major portion of the funds they lay out in order to get the business established and under way a strong inference arises that the entire amount paid in is a contribution to the corporation's capital and is placed at risk in the business.[1]

At the time of incorporation in 1929 real property with a fair market value of at least $2,700,000 was transferred to the Ruspyn Corporation in exchange for gold debenture bonds with a face value of $2,100,000 and capital stock with a par value of $600,000. The court cited the 4:1 ratio in the John Kelly Company case and decided the case under review had passed the debt-equity ratio test with a 3.5:1 ratio. It was also noted that $600,000 represented a substantial stock investment. In comparing this case to the John Kelley Company case the court was aware that the 4:1 debt-equity ratio computed on the basis of book values was not correct and the debt-equity ratio was computed using actual values. The Tax Court held that the securities represented indebtedness. The reasons for holding that the security represented debt were the absence of voting power,

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[1] Isidor Dobkin, supra at 33, 15 T.C. at 31.

the transferability of bonds without regard to the stock, a specific maturity date 89 years hence and a business purpose for the transaction. The specific maturity date of 89 years hence would appear to be in conflict with the Swoby Corporation case where 99 years was deemed not to be in the reasonable future.[1]

In Cleveland Adolph Mayer Realty Corporation real property was transferred from a former corporation to a newly organized corporation. The fair market value of the property transferred was in excess of $300,000 with an approximate value of $365,000. The shares of stock in the former corporation were exchanged for capital stock and debentures in the newly organized corporation. Three hundred shares of capital stock with a par value of $2 per share and debentures with a principal amount of $210,000 were issued to the stockholders who were parties to the exchange. The exact debt-equity ratio was not stated in the case, but using the range of values shown above the debt-equity ratio would range from 2.3:1 to 1.4:1. Either debt-equity ratio was below the 4:1 ratio established in the John Kelley Company case. The debentures in question had no voting rights, were freely transferable independent of the capital stock, paid six per cent interest monthly without regard to earnings, had a fixed maturity date eight years hence, unless lessee exercised an

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[1] Ruspyn Corporation, 18 T.C., 769 (1952)

11 year option renewal, and in that case the maturity date would be 19 years later. In the court's opinion a business purpose for the transaction was discussed in a circuitous way, but was not satisfactorily explained. The respondent pointed out that the petitioner was not interested in borrowing money as it could have been borrowed on a first mortgage at 5 per cent interest or less. The court felt that this factor was immaterial. The Tax Court held that securities in question did represent indebtedness.[1]

In holding that debenture bonds of petitioner represented indebtedness the Tax Court pointed out in New England Lime Company that there was a substantial amount invested in capital stock. Common stock was listed on the balance sheet without a stated value, but the petitioner was able to prove that in 1941 and 1942 that had been sales of common stock at prices ranging from 50¢ to $2 per share. A debt-equity ratio was not computed and the case does not provide enough information to compute the ratio. There were debenture bonds outstanding at December 31, 1941 of $538,100, but the court did not speak to the issue of an excessive debt structure. The court was satisfied that there was a substantial stock investment. Favorable characteristics of the debenture bonds included issuances in both registered and coupon form, a fixed maturity date 25 years hence, a set interest payment of

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[1] Cleveland Adolph Mayer Realty Corporation, 6 T.C., 730 (1946), reversed on other grounds, 160 F. 2d 1012 (6th Cir. 1947).

3 per cent with an additional 3 per cent unqualifiedly fixed if earned, wide and disproportionate distribution of stocks and bonds, and shift of voting power to common stockholders. The court felt that the desire to give the officers and others voting rights on their common shares was a clear business purpose. It is interesting to note that management in connection with the exchange of preferred shares for debenture bonds pointed out to the preferred shareholders that interest on the debenture bonds could be deducted for federal income tax purposes.[1]

In Gazette Telegraph Company there was stockholder held indebtedness of $250,000 and capital stock of $250,000, a debt-equity ratio of 1:1. The Tax Court decided that this was not a case of thin capitalization. The securities were called notes payable, paid a 5 per cent rate of return and had a ten year maturity date. The family members who represented the stockholding interest in the corporation were also stockholders in several other family corporations operating newspapers. The stockholders indicated that the indebtedness served several business purposes. The indebtedness provided necessary liquid funds for future business expansion or the payment of estate and inheritance taxes should one of the shareholders die. The indebtedness was also better than stock as collateral for borrowing and in the event of

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[1] New England Lime Company, 13 T.C., 799 (1949).

bankruptcy shareholder held debt would be on a par with other unsecured indebtedness. The family wanted to be able to withdraw funds without a change in the proportion of equity ownership. The Tax Court held that the notes payable represented bona fide indebtedness. Several other interesting points were present in this case. Initially $500,000 was borrowed from the Bank of America. The bank required that certain family members and another family corporation sign individual notes and pledge securities they owned as collateral. Originally the family had purchased the stock of an existing corporation and immediately liquidated the corporation and assets were distributed to the buyers as tenants in common. Subsequently assets were transferred to petitioner in exchange for $250,000 stock, $250,000 notes payable to the family shareholders, and $410,000 payable to the Bank of America. When the $410,000 bank loan became due a new loan of $400,000 was made by the same bank. The bank did require one of the family corporations be jointly liable on the $400,000 loan since the bank needed additional security.

Originally the respondent contended that the bank loan also represented an equity interest, but later dropped that contention. The debt-equity ratio, including the Bank of America loan, was approximately 2.6:1. The facts presented indicated a $250,000 capital structure was adequate to operate the business and meet the requirements of paper suppliers, news services, and syndicates.[1]

The preceding four cases provide examples of low debt-equity ratios and in each case the Tax Court held that the securities represented indebtedness. The Tax Court in each of the cases dealt with the issue of substantial as opposed to nominal stock investments. In three of the cases a debt-equity ratio was calculated and discussed. There was much less emphasis on the debt-equity ratio in these cases than there was in cases with high debt-equity ratios. The Tax Court followed a 4:1 standard for the debt-equity ratio. In these cases the court simply cited the John Kelley Company case and noted that the standard of 4:1 established in that case had been met.

Thus far there has been a close correlation between decisions rendered by the Tax Court and the 4:1 debt-equity ratio standard established in the John Kelley Company case. In the cases with debt-equity ratios in excess of 4:1 the Tax Court has consistently held that securities represented equity. In cases with debt-equity ratios less than 4:1, the Tax Court has consistently held that securities represented indebtedness. The debt-equity ratio in the New England Lime Company case may have exceeded a 4:1 ratio. In that case the court emphasized the substantial stock investment without

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[1] Gazette Telegraph Company, 19 T.C., 692 (1953), affirmed on other grounds, 209 F. 2d 926 (10th Cir. 1954).

computing a debt-equity ratio. Review of the following cases will indicate that the 4:1 debt-equity ratio standard was not consistently followed by the Tax Court.

In The Toledo Blade Company a recapitalization plan provided for the issuance of $3,000,000 of debentures and $500,000 of common stock by a wholly owned subsidiary corporation to its parent corporation in exchange for the outstanding shares of capital stock. The Tax Court felt there was no question that the debentures were genuine and evidenced legal obligations of the subsidiary corporation. The debentures had a fixed maturity date of six years, bore interest at 7 per cent, and principal and interest were both unconditionally payable. The Tax Court felt that the facts presented in this case followed the pattern of the John Kelley Company and Cleveland Adolph Mayer Realty Corporation. A debt-equity ratio was not shown in the Tax Court opinion, but the ratio was 6:1. This debt-equity ratio exceeds the 4:1 standard which had been used by the Tax Court. The respondent in the case felt that the whole transaction was a sham and was motivated because of tax savings rather than any bona fide business purpose. In rejecting the validity of the business purpose test the Tax Court cited the John Kelley Company case where the right of stockholders to convert to a creditor-debtor relationship for purely personal reasons was upheld. The Tax Court held that the alleged debentures did in fact represent indebtedness.[1]

In Arthur V. McDermott eight heirs of an estate conveyed certain real property, valued at $108,418, to a corporation in exchange for unsecured promissory notes. Each heir was issued a note for $12,500 and three of the heirs were issued additional notes totaling $8,418. Certain liquid assets valued at $5,533.36 were transferred by the heirs to the corporation and each of the heirs was issued five shares of no par value common stock. The notes provided for a 6 per cent interest rate, were unsecured, were payable on demand except five of the eight noteholders had to join in a demand for payment. The debt-equity ratio in this case was approximately 20:1. In referring to the fact that stock was issued in exchange for personal property and notes were issued for real property it was stated:

> The notes and the stock were issued for entirely distinct kinds of property, which indicates rather clearly the intent of the heirs to differentiate between their respective interests as creditors and as stockholders.[2]

The disproportion between the debt and equity interests of the stockholders, caused by the issuance of $8,418 of additional notes among three of the heirs, was viewed

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[1] The Toledo Blade Company, 11 T.C., 1079 (1948), affirmed on other grounds. 180 F. 2d 357 (6th Cir. 1950), cert. denied 340 U.S. 811 (1950).

[2] Arthur V. McDermott, 13 T.C., 468, 471 (1949).

favorably by the court. A business purpose was offered for organizing the corporation, but no business purpose was established for the issuance of a substantial amount of debt. Business purpose was not discussed in the Tax Court's opinion. Intent was discussed at great length and in this regard it was indicated that interest was consistently paid on the notes which showed the intent of the parties concerned. The Tax Court held that the securities in this case did represent indebtedness.[1]

The cases presented in this chapter indicate that the courts continued to judge cases on the basis of the factors presented in the preceding chapter, but added the debt-equity ratio as an additional factor. The debt-equity ratio had its beginning in the dictum of the John Kelley Company case and was considered by the courts in the majority of cases reviewed in this chapter. As has been shown, the debt-equity ratio of 4:1 developed from the Talbot Mills case, a companion to the John Kelley Company case in the Supreme Court. The standard of a 4:1 debt-equity ratio was not always followed, but was used with a degree of consistency.

The necessity of a bona fide business purpose for issuing stockholder held indebtedness was not consistently required by the courts. In some cases a bona fide business purpose seemed to be a very strong factor influencing the

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[1] Ibid., at 468.

court's decision favorable to the taxpayer. In other cases the lack of a business purpose seemed instrumental in the court's rendering a decision unfavorable to the taxpayer. In other cases business purpose was ignored, while in one case it was indicated that if stockholders wanted to change from a stockholding interest to a creditor interest it was purely a personal matter.

Several other developments of this period were interesting. When both debt and equity instruments are issued by a corporation to its stockholders in exchange for property the portion of the property applicable to each should be identified. The same proportion of debt to equity for each stockholder has been viewed by the courts as an indication that alleged debt represented equity. One case involved the use of two types of debt instruments which was looked upon favorably by the court. Bank borrowing by a corporation with individual stockholders guaranteeing the loan was illustrated in one case.

The activity of the courts between 1946 and 1956 indicated an emphasis on material amounts of equity, realistic debt structures, and confusion concerning the necessity for a business purpose.

CHAPTER V

PERIOD FROM 1956 TO PRESENT

Prior to this period the courts had developed certain criteria which were used in determining whether property transferred to a closely held corporation by its stockholders created a debtor-creditor relationship or a stockholding relationship. The factors established by the courts have been reviewed in the preceding chapters. During a ten-year period immediately prior to the current period the courts emphasized the factor of the debt-equity ratio in deciding whether a security represented indebtedness or equity. The court's interpretation of the debt-equity issue will be reviewed in this chapter with emphasis on new developments representing either additional factors or changing emphasis on established criteria used by the courts.

In 1946 petitioner corporation, Gooding Amusement Company,[1] was organized. At the time the corporation was organized a husband, his wife, and daughter were the only stockholders. Prior to 1943 the family had conducted the same basic business operation as a corporation. From 1943 to 1946 the three stockholders had operated substantially

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[1] Gooding Amusement Company, 23 T.C. 408 (1954), affirmed 236 F. 2d 159 (6th Cir. 1956), cert. denied 352 U.S. 1031 (1957).

the same business operation as a partnership. The partnership interests of the husband, wife, and infant daughter were respectively, four-sevenths, two-sevenths, and one-seventh. In 1946, concurrently, with the distribution of the partnership assets, the partners exchanged the distributed assets for shares of stock and notes payable of the newly organized corporation. The distributed partnership assets were appraised and exchanged, to the corporation, for a higher value than had been recorded on the partnership books. In exchange for the assets received by the corporation no-par common stock with a total stated value of $49,000, and notes payable of approximately $232,000 were issued to the husband, wife, and daughter with both issuances prorated four-sevenths to the husband, three-sevenths to the wife, and one-seventh to the daughter.

The Tax Court in their opinion discussed the debt-equity ratio. The Tax Court indicated if a reasonable value was attributed to goodwill, the debt-equity ratio was approximately 1:1. The Tax Court noted that the debt-equity ratio was one of several criteria which should be considered in determining the presence or absence of a debtor-creditor relationship, but this criterion alone was not decisive.

The factor of a bona fide business purpose for the transaction was also discussed by the Tax Court. An officer of Gooding Amusement Company contended that the risks attendant to the operation of an amusement business subjected the corporation to the possibility of liability so great that the business could have become insolvent. The stockholder-creditors, in the event of insolvency, could then have been on a par with other unsecured general creditors to the extent of their notes and recoup some portion of the corporate assets which would probably not have been the case if they were stockholders only. The Tax Court noted that the liability insurance carried appeared to be adequate to cover claims that could occur as the result of accidents. The Tax Court also pointed out that in 1943, only three years prior to 1946, when the risk of liability because of accidents was about the same, the stockholders of petitioner corporation had converted from a corporate organization to a partnership organization. Petitioner corporation indicated that it was necessary to keep the capitalization comparatively small so shares of stock could be issued to key employees. The Tax Court saw no reason why this objective could not have been achieved regardless of the amount of corporate capitalization.

The Tax Court indicated that the formal attributes of indebtedness had been satisfied by the terms and conditions of the notes. The notes represented an unconditional promise to pay a definite amount at a fixed time, with interest payable at a fixed rate and in all instances.

The form of the notes satisfied the Tax Court, but the substance of the transaction did not. In the Tax Court's opinion the most significant aspect of this case was "the complete identity of interest between and among the three noteholders, coupled with their control of the corporation."[1] The Tax Court pointed out that two of the stockholders, the wife and daughter, had not intended and, in fact, had not, operated independently in enforcing the payment of notes they held. The major stockholder did not intend to enforce payment of the notes if it would impair the corporation's credit rating, cause the corporation to borrow funds from other sources to pay off the notes, or bring about the dissolution of the corporation. The notes had been subordinated to claims of other creditors and had not been repaid at maturity.

In its opinion the Tax Court summarized the cogent factors of the case when it stated:

> The only substantial purpose motivating the transaction was one of tax avoidance. When this fact is considered, together with the extent to which the notes were subordinated to the claims of creditors, the reality of the amenability of petitioner's wife and infant daughter to his desires in respect of the notes, and the absence from the transaction of any true borrowing element or new contribution to the enterprise, we must conclude that no indebtedness arose between the Goodings and the corporation.[2]

In this case the Tax Court emphasized the lack of a bona fide business purpose for the issuance of notes to the stockholders and gave no special weight to the absence of an

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[1]Gooding Amusement Company, supra at 43, 23 T.C. at 418.

[2]Ibid., at 421.

excessive debt structure and the presence of a substantial stock investment. The new factor presented by the Tax Court was the identity of interest among the stockholder-creditors combined with their control of corporate affairs.

The case was appealed to a Circuit Court of Appeals and the decision of the Tax Court was affirmed.[1] The case was then appealed to the United States Supreme Court, but certiorari was denied.[2]

The courts continued to consider the intent of the stockholder-creditor in determining whether an instrument evidenced indebtedness or equity. The court indicated in Fellinger v. United States that:

> determination of a taxpayer's intent rests upon his objective intent as disclosed by the various factors in the case and not just upon his own formal manifestations.[3]

In the Fellinger case the stockholder-creditors were issued both bonds and stock as a package. The testimony of stockholders supported the court's finding that the stockholders would not have advanced money to the corporation unless they acquired an ownership interest therein. The fact that a sinking fund had not been provided by the corporation to retire the bonds at maturity was considered by the

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[1] Gooding Amusement Company v. Commissioner, 236 F. 2d, 159 (6th Cir. 1956).

[2] Gooding Amusement Company v. Commissioner, 352 U.S., 1031 (1957).

[3] Fellinger v. United States, 238 F. Supp., 67, 75 (1946).

court as one of the criteria indicating that the bonds represented equity. The bondholders had voting rights which required 75 per cent in the amount of bonds to vote and declare the bonds due and payable if the corporation was in default and a vote of the same percentage in the amount of bonds could alter the provisions of the bonds. Evidence in the case indicated that bond repayments were dependent on corporate earnings.[1]

The preceding case involved one of the stockholders of The Hippodrome Building Company and the taxability of certain income on his individual tax return. Essentially the same facts were considered by the Tax Court in a case in which The Hippodrome Building Company was the plaintiff. The Tax Court emphasized the subordination of the bonds to interests of other creditors. The Tax Court in referring to funds advanced by the stockholders stated:

> It is obvious that the funds supplied by the Babin group did not constitute an addition to adequately existing operating capital, but represented instead an advance of necessary working capital without which the corporation would not have been able to continue.[2]

Other than the above points the opinion of the Tax Court was essentially the same as that of the District Court in the Fellinger case.[3]

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[1] *Ibid.*, at 67.

[2] *The Hippodrome Building Company*, P.H. Memo T.C., 65-125, 65-134 (1965).

[3] *Ibid.*, at 65-125.

Both of the two preceding cases were appealed to the United States Court of Appeals.[1] The decisions in both cases were affirmed and accordingly the bonds in question were held to represent equity interests.

In Broadway Drive-In Theatre, Inc., v. United States[2] the testimony of corporate stockholders was revealing. One stockholder testified that he did not expect to have his loans paid back if the business was unsuccessful and another stockholder testified that the first loan by stockholders was made so the corporation would have some capital to operate the business. In addition to the testimony, cash flow statements for the corporation indicated that negative cash balances would have resulted if the stockholders had not loaned the corporation money. Without the stockholder loans, regular operating expenses and the construction costs of the drive-in movie theatre could not have been paid. The corporation's debt-equity ratio is closely related to the preceding issue. At the time the corporation was organized, or within a few months, the stockholders advanced $43,140, and the corporation issued promissory notes for $42,640 and common stock of $500. Considering only stockholder held debt, the debt-equity ratio was approximately 85 to 1. If all corporate debt was included, the debt-equity ratio was 411 to 1.

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[1] Fellinger v. United States, 363 F. 2d, 827 (6th Cir. 1966), affirming 238 F. Supp. 67 (1964).

[2] Broadway Drive-In Theatre, Inc. v. United States, 220 F. Supp. 707 (1963).

No evidence was presented to the court concerning a bona fide business purpose for the stockholders loaning money to the corporation instead of investing capital. The court recognized that the alleged instruments of indebtedness were in form evidences of a debt. The promissory notes provided for a definite interest payment, a fixed maturity date and were negotiable.

The court held that the stockholder-held promissory notes of Broadway Drive-In Theatre represented equity. In addition to the negative criteria mentioned above, the court indicated that several other factors were detrimental to the taxpayer in attempting to prove his case. Initially the money received by the corporation from the stockholders for both laons and stock was recorded in a suspense account with a subsequent reclassification of amounts to the respective accounts. The loans were not repaid at maturity and interest was accrued but was not paid on the notes. The corporation did repay the loan of one stockholder, plus accrued interest, but two years subsequent to the maturity date, and at the same time purchased his shares of common stock. Also detrimental to the taxpayer's case was the absence of demand by the stockholder-creditors for payment of principal and interest when due, the fact renewal notes were not issued when the notes matured, and that it would not have been reasonably expected when the notes were issued that the principal would be repaid at maturity. Three of the four shareholders loaned the corporation money in proportion to shareholder ownership.

In Harkins Bowling, Inc. v. District Director[1] stockholders advanced $91,000 to a corporation and were issued notes in the principal amount of $90,000 and capital stock of $1,000. Within the first year the corporation was in existence the stockholders advanced an additional $19,650 to the corporation and in exchange received notes. Considering only stockholder held debt, the debt-equity ratio was 109 to 1, but inclusion of debt to other creditors resulted in a debt-equity ratio of 366 to 1. The stockholder advances which were exchanged for notes were used to purchase assets necessary for the basic operation of the business. Advances by stockholders in exchange for notes were proportional to each stockholder's equity interest in the corporation. The court, in this case, considered the above criteria indicative of an equity interest. The court also considered whether a commercial lender would have loaned the corporation money with a stockholder investment of only $1,000. Evidence presented showed that a commercial lender would not have loaned the corporation money unless the stockholders advanced $91,000 and subordinated stockholder held debt to the lender's loan. Expectation of repayment of the stockholder held debt

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[1] Harkins Bowling, Inc. v. District Director, 164 F. Supp. 801 (1958).

was, in effect, contingent upon very substantial corporate earnings. Secured debt repayment of outsiders had to be paid first from earnings and enforced payment of stockholder held debt would have jeopardized the financial condition of the corporation. For the above reasons the court decided that the stockholder held notes in Harkins Bowling represented an equity investment.

In Affiliated Research, Inc. v. United States[1] three brothers who were shareholders in a family corporation and an estate in which the brothers were co-executors and sole beneficiaries advanced money to the corporation and received in return promissory notes. The money was advanced by the stockholders so the corporation could purchase capital stock of another company. The stockholder loans were evidenced by promissory notes which were payable on demand, but for almost the entire period involved the notes were subordinated to the indebtedness of other corporate creditors. Repayment of the promissory notes by the plaintiff corporation was dependent on substantial earnings by the company in which they had purchased shares of stock. Each stockholder's portion of the indebtedness was proportional to his stock ownership. The ratio of shareholder debt to equity was approximately 72 to 1, while the debt-equity ratio was 131 to 1 if bank loans

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[1] Affiliated Research, Inc. v. United States, 351 F. 2d 646 (Ct. Cl. 1965).

were included. The court compared the safeguards required by the banks in loaning money to this corporation with the absence of the same safeguards in connection with stockholder held debt. The court stated:

> Perhaps the most effective way to demonstrate certain of the reasons for our decision would be to contrast the bank loans, on the one hand, and, on the other, the advances by the Freydbergs and the estate.[1]

The court concluded that the outside lending institutions required personal guarantees, the pledge of securities, and subordination of other loans while the stockholders required no such protection which placed them in a position of greater risk. The court held that the promissory notes of Affiliated Research, Inc. represented equity ownership.

In securing funds for operation in Utility Trailer Manufacturing Company v. United States[2] plaintiff corporation made it a practice to borrow from banks for current financing and to borrow from stockholders, key employees, and relatives of stockholders for long term financing. The loans from stockholders and key employees began in 1941. On September 30, 1949 promissory notes then aggregating $367,500 were cancelled and new unsecured promissory notes were issued which extended the maturity dates of the notes. On October 31, 1952

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[1] Ibid., at 648.

[2] Utility Trailer Manufacturing Company v. United States, 212 F. Supp. 773 (1962).

the promissory notes issued in 1949 were exchanged for notes which gave the holder the option to convert them into stock. Between October 31, 1952 and April 1, 1954 an additional $195,300 was borrowed by the corporation from stockholders and key employees and unsecured promissory notes were issued in exchange. On April 1, 1954 the corporation issued notes in the aggregate amount of $557,700 in exchange for notes which had previously been issued to shareholders and key employees. Notes with the aggregate amount of $5,100 were converted into common stock of the corporation. The notes issued on April 1, 1954 provided an escalation clause as a hedge against inflation which was computed with reference to the Consumer Price Index. The maturity dates for these notes ranged from September of 1965 to September of 1972.

The court indicated that the notes of the Utility Trailer Manufacturing provided for a definite determinable date on which the principal was due even though no payment had been made on the principal of any of the notes. The absence of demand for repayment of principal of the notes was not considered by the court as evidence of the intent of stockholders and employees to treat the notes as equity capital. The court concluded that it was reasonable to assume that shareholders and employees intended when they loaned the money to have it repaid at maturity, but because of the continuous growth and expansion of the company, with the accompanying need for additional funds, had decided to extend the maturities of the loans. The loans were made in reasonably close proportion to stockholdings, but this was offset by the fact that the loans were not made at the same time the stockholders purchased stock in the company. The notes in question were not subordinated to the claims of general creditors but there was a limited subordination to a loan by an insurance company. The court felt that the subordination was so limited that it was not a significant factor indicative of an equity interest. In referring to the factor of subordination the court cited a case in which it was stated:

> Subordination to general creditors is not necessarily indicative of a stock interest. Debt is still debt despite subordination.[1]

The debt-equity ratio of the Utility Trailer Manufacturing Company was less than one to one and the court indicated that the corporation was not thinly capitalized. The defendant in this case had not questioned the deduction of interest paid to noteholders who were not stockholders. The court pointed out that this was illogical since the important factor was not who owned the notes, but instead the true nature of the notes. The court held that the alleged notes of the Utility Trailer Manufacturing Company did in fact represent indebtedness.

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[1] Kraft Foods Company v. Commissioner, 232 F. 2d, 118, 125 (2d Cir. 1956).

The court in O. H. Kruse Grain & Milling v. Commissioner[1] found most of the governing attributes lacking in a promissory note held by the major stockholder. The maturity date of the note was certain only to the extent that it was payable on or before a specified date or thereafter on demand. The stockholder and his wife, who was also a stockholder, owned 100 per cent of the stock which indicated that there was complete identity of interest between noteholder and stockholder. The note was subordinated to the claims of other creditors for most of the period the note was outstanding. The noteholder-stockholder participated in management, evidence of a bona fide business purpose for the note issuance was not presented, and payments were made on the principal of the demand note only after internal revenue authorities questioned the genuineness of the note. No evidence was presented to show that the money could have been borrowed from outside sources, but the court indicated that due to the liberal provisions of the note the probability of a lending institution granting such a loan was small. The court found only the form of the promissory note to be indicative of indebtedness and held that the alleged note represented an equity interest.

The sole shareholder in P. M. Finance Corporation v.

[1] O. H. Kruse Grain & Milling v. Commissioner, 279 F. 2d, 123 (9th Cir. 1960).

Commissioner[1] purchased capital stock in the corporation with the par value equal to the cost of $10,000. The sole shareholder also advanced $90,000 to the corporation and received in exchange debenture bonds with a principal amount of $90,000. Subsequently his wife purchased debenture bonds of the corporation with a principal amount of $50,000. The corporation also borrowed very substantial sums from banks. The corporation under review was in the business of lending money to finance purchases of tap rooms and cocktail lounges. The collateral backing the corporation's notes receivable was pledged to the banks as security for loans. Since borrowed capital, in large amounts, is customary in the finance business, the debt-equity ratios which ranged from 7:1 down to 3:1 were not considered by the court to be too high. The complete identity of interest between the bondholder-sole shareholder and his wife, the other bondholder, was a factor indicating that the bonds represented equity. In this regard the court stated:

> To the sole shareholder-creditor it may make little difference, taxation aside, whether his investment be labeled debt rather than stock. Complete control of the corporation will enable him to render nugatory the absolute language of any instrument of indebtedness.[2]

The subordination of the bonds to bank loans was the

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[1] P. M. Finance Corporation v. Commissioner, 302 F. 2d, 786 (3rd Cir. 1962).

[2] P. M. Finance Corporation v. Commissioner, supra at 56, 302 F. 2d at 789, 302 F. 2d, 786, 789 (3rd Cir. 1962).

major factor the court considered in deciding that the bonds represented an equity interest. The subordination was complete and bondholders could not demand payment of the bond principal at a fixed maturity date nor could they share with general creditors in the assets of the corporation upon liquidation or dissolution. It was basic to the operation of this business that bank loans be sustained at a high level and this, combined with the subordination, meant that the debentures would not be subject to payment for an indefinite period of time which would probably extend for the period of time the corporation existed.

The Colony, Inc.[1] corporation was organized with a total capital of $1,000 and indebtedness payable to stockholders of $57,800. Bank loans totaling $149,000 were obtained and were secured by liens on real estate owned by the corporation. The promissory notes issued to stockholders were unsecured, were not repaid at maturity, but were issued in amounts that were disproportionate to stockholdings. Representatives of the taxpayer corporation conceded that it was thinly capitalized. The debt-equity ratio counting only stockholder held debt was 58 to 1, and the inclusion of indebtedness to outsiders increased the ratio to 207 to 1. The court considered the nominal stock investment, the

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[1] The Colony, Inc., 26 T.C., 30 (1956), aff'd without discussion of this point, 357 U.S. 28 (1958).

excessive debt structure, implied subordination by the parties, and the absence of enforcement of principal payment of the notes at maturity to indicate that the stockholders intended for the alleged loans to be risked in the business as a capital contribution.

In Emanuel N. Kolkey[1] three individuals who owned all of the stock in a corporation transferred their stock to a newly organized corporation in exchange for promissory notes with an aggregate amount of $4,000,000. There was a stock investment of $1,000. The court in holding that the alleged promissory notes represented equity emphasized the nominal stock investment, the excessive debt structure, the fact that the business operation of the new corporation was nearly identical to that of the former corporation and the absence of intent of the parties to enforce collection of the promissory notes.

Three joint owners of certain real estate formed Burr Oaks Corporation[2] and transferred the real estate to the corporation in exchange for promissory notes. Each of the individuals received promissory notes with a face value of $110,000. Wives or brothers of the three individuals purchased capital stock at a cost of $4,500. The control of corporate affairs was exercised by the three noteholders

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[1] Emanuel N. Kolkey, 27 T.C. 37 (1956), aff'd 254 F. 2d 51 (7th Cir. 1958).

[2] Burr Oaks Corporation, 43 T.C., 635 (1965), aff'd 365 F. 2d 24 (7th Cir. 1966).

rather than the stockholders. The court emphasized the nominal stock investment, excessive debt structure, the absence of intent to enforce collection of the note principal, and the control of corporate affairs by the noteholders. It was also pointed out that the source of interest and principal payments would have to be from earnings derived from the successful operation of a risky and speculative business. The court held that the alleged promissory notes represented an equity interest.

The criteria generally used by the courts in determining whether amounts advanced to a corporation, by its stockholders, represented indebtedness or equity capital were stated in the opinion of a United States Court of Appeals case. These criteria were: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce the payment of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) thin or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of dividend money; (11) the ability of the corporation to obtain loans from outside lending institutions.[1] These same

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[1] Montclair, Inc., v. Commissioner, 318 F. 2d, 38, 40 (5th Cir. 1963).

factors were used by the court in a case previously cited.[1]

In a very recent case decided in a United States District Court[2] and appealed to a United States Court of Appeals the same criteria were used in determining whether alleged indebtedness did in fact represent indebtedness or equity. The corporation was organized in 1955 for the purpose of constructing, owning, and operating a professional office building. For each share of stock purchased the stockholder agreed to advance $400 to the corporation as a loan. Originally the loans were evidenced by promissory notes, but two years after the corporation was organized debentures were substituted for the notes. The debentures provided for 7 per cent interest payment, which was cumulative, and accumulated interest had to be paid before dividends on capital stock could be declared. The principal of the debentures was payable on or before 19 years subsequent to the date of issuance and maturity could be accelerated for any default other than the failure to pay interest. The debentures were freely transferable and were secured by a pledge of the full faith and credit of the issuer by a lien upon all excess lease rentals received by the corporation and the proceeds, if any, of a stockholder's loan sinking

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[1] O. H. Kruse Grain & Milling v. Commissioner, supra at 55, 279 F. 2d at 125.

[2] The 1661 Corporation v. Laurie W. Tomlinson, 247 F. Supp. 936, (1965), aff'd Commerce Clearing House, 67-1 U.S.T.C. 84-210 (5th Cir. 1967).

fund to which no deposits had been made. The debentures were subordinated to the mortgage indebtedness on corporate property.

The court considered that the identity of ownership between debenture holders and stockholders of The 1661 Corporation and the stockholders' proportional holding of debentures and stock was offset by the free transference of the debentures. The fact the status of debenture holders was inferior to that of a mortgage holder was offset by the equal status of debenture holders and general creditors of the corporation. The court concluded that the debt-equity ratio, which was 4:1, if only stockholder held debt was included, and 14.6:1 if all debt was included, was not excessive. The court also indicated that there was a definite right to enforce payment of debenture principal upon default or at maturity. The corporation had accrued interest on the debentures for several years, but the interest remained unpaid. The court gave very little weight to the fact that debenture holders had not exercised their right to enforce payment of interest. In discussing intent the court referred to a prior case wherein they had stated:

> Where the instruments involved are entirely conventional in form and contain no ambiguity on their face, the problem is not one of ascertaining intent since the parties have objectively manifested their intent. It is a problem of whether the intent and acts of these parties should be disregarded in

characterizing the transaction for federal tax purposes.[1]

The court concluded that The 1661 Corporation could have secured loans from outside sources, but the interest rate was prohibitively high. The court held that the debentures represented indebtedness.[2]

Many of the criteria used by the courts in prior periods were used by the courts during this period to determine whether an instrument represented indebtedness or equity. The debt-equity ratio was not emphasized as much by the courts. Between 1946 and 1956 a debt-equity ratio of 4:1 or less was considered by the majority of courts to indicate that the debt structure was not excessive. Several of the cases during this period involved corporations with a debt-equity ratio of 1:1 or less in which the court held that instruments under review did not represent bona fide indebtedness.

The ability of a corporation to obtain loans from outside lending institutions is a factor that was first used by the courts during this period. If an outside creditor in an arms length transaction would loan the corporation money, this was a factor which indicated that the risk attendant to the loan was not so great as to preclude

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[1] United States v. Snyder Brothers Company, 367 F. 2d, 980, 982 (5th Cir. 1966).

[2] Tomlinson v. The 1661 Corporation, Commerce Clearing House, 67-1 U.S.T.C. 84-210 (5th Cir. 1967).

stockholder advances from being given the status of bona fide indebtedness.

The factor of identity of interest between creditor and stockholders was expanded during the current period. Prior to this period stockholders holding the same proportion of indebtedness and stock was detrimental in proving that indebtedness was bona fide. Proportional holdings of debt and stock continued as a factor indicating indebtedness. The Gooding Amusement Company[1] expanded the doctrine of identity of interest. The complete dependence of certain stockholders on the decisions of the major stockholder made it apparent that only the intent of the major stockholder was important.

Practically all of the cases decided by the courts during this period involved instruments which in form satisfied the requirements for indebtedness. The courts concentrated on the substance of an alleged indebtedness arrangement in deciding whether a security represented indebtedness or equity. The substance of an alleged indebtedness arrangement was closely related to objective intent. The criterion of intent was not governed by what a taxpayer subjectively intended, but by what could reasonably be inferred from the terms and conditions of the instrument and evidence outside the contract.

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[1] Gooding Amusement Company, supra at 43.

The approach of the courts during this period appeared to be more comprehensive with emphasis on the economic reality of a transaction as opposed to formal characteristics of indebtedness.

CHAPTER VI

CONCLUSION

The court's interpretation of the concepts of corporate indebtedness and equity resulting from shareholder loans and investments has changed substantially between 1913 and the present. The criteria developed by the courts in the earlier years have been used by the courts up to the present. In addition the courts have developed and added significant new criteria to judge whether instruments represent debt or equity. In the pre-1946 period courts concentrated primarily on the formal aspects of the stockholder-creditor arrangement and the subjective intent of the parties to the transaction. The courts have gradually changed the emphasis and they now concentrate more on the substantive aspects of a shareholder-creditor arrangement and the objective intent of the parties to the transaction. The following summarizes factors the courts consider in interpreting the concepts of corporate indebtedness and equity resulting from shareholder loans and investments.

The courts have consistently considered the name of an instrument since, "it is not lightly to be assumed that the parties have given an erroneous name to their transaction."[1] The name of an instrument, however, is not conclusive evidence that a security represents indebtedness since the real character of the instrument may be different from the name by which it is denominated.[2] The real character of an instrument named debenture preference stock[3] was found by the courts to be indebtedness. The consistency of using the instrument's name in other corporate records is also important in determining the intent of the parties. Minutes and resolutions of board of directors meetings and stockholder agreements should consistently refer to the name of the instrument.[4] The use of suspense accounts to record advances from shareholders in the financial records should be avoided.[5]

The presence or absence of a fixed maturity date in an instrument is important in proving to the courts that a debtor-creditor relationship was intended. Some court decisions indicate that a fixed maturity date for the principal sum is the most significant and essential feature of a debtor-creditor relationship.[6] However, a fixed maturity date for a security

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[1] Appeal of Kentucky River Coal Corporation, supra at 19, 3 B.T.A., at 649.

[2] Appeal of Leasehold Realty Company, supra at 10.

[3] The Proctor Shop, Incorporated, supra at 11.

[4] Appeal of I. Unterberg & Company, supra at 23.

[5] Broadway Drive-In Theatre, Inc. v. United States, supra at 49.

[6] Parisian, Inc. v. Commissioner, supra at 19.

does not conclusively prove that an instrument represents indebtedness since it may lack certain other essential features.[1] In the opinion of a court decision it was indicated that it is not uncommon for preferred stock to provide for a fixed maturity date.[2] When debt securities are issued the maturity date should be either fixed or determinable.

Another feature of a debtor-creditor relationship the courts have considered essential is certainty that the principal indebtedness will be repaid. This feature was given great weight in one court opinion when it was stated, " the final criterion between creditor and shareholder we believe to be the contingency of payment."[3] The right to enforce payment of the principal indebtedness upon default or at maturity has been a criterion construed by the courts to indicate a debtor-creditor relationship. Shareholder loans secured by the pledge of collateral or by a mortgage have a greater probability of being interpreted by the courts as representing indebtedness. Subordination of the claims of shareholder-creditors to the claims of general creditors is construed by the courts as an attribute indicating that

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[1] P. M. Finance Corporation v. Commissioner, 302 F. 2d 786 (3rd Cir. 1962).

[2] Appeal of Leasehold Realty Company, supra at 10.

[3] Commissioner v. O. P. P. Holding Corporation, supra at 12, 76 F. 2d at 12.

shareholder loans are risk capital. Subordination of shareholder loans to specific claims of corporate creditors is not necessarily fatal to the taxpayer's proving his case to the court.[1] Creditor safeguards are many and varied, but normal creditor protection should be provided in a shareholder-laon agreement.

Instruments of indebtedness should provide for a fixed rate of interest payable in all instances. The corporation should be unconditionally bound to pay a definitely ascertainable amount of interest without regard to corporate profits or retained earnings. The requirement that the source of interest payments must be corporate profits or retained earnings has been viewed by the courts as a factor indicative of a stockholding interest.[2] Conversely an unconditional requirement by the corporation to pay a fixed amount of interest under all circumstances is considered by the courts as indicative of indebtedness.[3] The right of stockholder-creditors to share in corporate profits beyond a fixed interest rate is generally considered by the courts as indicative of a stockholding relationship.[4] Generally the courts indicate that cumulative interest payments provide

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[1] Tomlinson v. The 1661 Corporation, supra at 60.

[2] Commissioner v. Schmoll Fil Associated, Inc., 110 F. 2d 611 (2d Cir. 1940).

[3] The Toledo Blade Company, supra at 40.

[4] Haffenreffer Brewing Company v. Commissioner, supra at 20.

evidence of indebtedness,[1] but this may not be reliable since in many instances dividends on preferred shares are cumulative. The right of stockholder-creditors to enforce collection of interest upon default is considered by the courts as a criterion favoring the interpretation of bona fide indebtedness.[2] An instrument that provides with certainty that interest will be paid is viewed favorably by the courts in a debt-equity determination.

The courts generally construe the right of security holders to vote or participate in the management of corporate affairs as a feature indicative of a stockholding interest.[3] The absence of these features can be indicative of an indebtedness interest.[4]

Much has been covered in this study about the debt-equity ratio. For several years a debt-equity ratio. For several years a debt-equity ratio of 4:1 or less was considered by taxpayers as safe. Taxpayers felt that within these limits courts would not interpret the corporation's debt structure to be excessive or the stock investment to

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[1] Commissioner v. O. P. P. Holding Corporation, supra at 12.

[2] The Proctor Shop, Incorporated, supra at 11.

[3] Fellinger v. United States, supra at 48.

[4] John Kelley Company v. Commissioner, 326 U.S. 521 (1946) reversing 146 F. 2d 466 (7th Cir. 1944) reversing 1 T.C. 457 (1943).

be nominal.[1] Since the Gooding Amusement Company[2] case the debt-equity ratio has not been given as much weight by the courts. The debt-equity ratio is still one of the criteria considered by the courts. Corporations with excessive debt structures or nominal stock investments still run the risk of having alleged instruments of indebtedness interpreted by the courts to represent equity interests. Lower debt-equity ratios are less probable of equity interpretation by the courts.

A bona fide business purpose for creating a shareholder-creditor arrangement generally supports the taxpayer's contention that the indebtedness is genuine. Conversely, if the transaction has tax avoidance as its primary purpose, then the courts tend to construe this factor as indicative of a stockholding relationship. Several examples of a bona fide business purpose for a debtor-creditor transaction are included in this study. Possible business purposes are many, but a business purpose other than a tax avoidance provides a favorable criterion pointing to bona fide indebtedness.

Identity of interest between creditor and stockholder is a factor that has been consistently considered by the courts in debt-equity determinations. Alleged indebtedness which involves stockholders who are also the creditors is a

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[1] Ibid.

[2] Gooding Amusement Company, 23 T.C. 408 (1954), aff'd 236 F. 2d 159 (6th Cir. 1956), cert. denied 352 U.S. 1031 (1957).

factor indicating a stockholding relationship.[1] This is especially true when the stockholder held debt is divided among stockholders in the same proportion as their stockholdings. The courts tend to construe proportionate holdings of stock and stockholder debt as leaving stockholders in the same position of risk with the same participation in management of corporate affairs as would have been the case if they had invested money in the corporation. Where certain stockholder-creditors have not operated independently of other stockholder-creditors the intent of the controlling party has been determined.[2] Disproportionate holdings of stock and debt and independence of action by stockholder creditors have been viewed favorably by the courts as criteria indicating bona fide indebtedness.

The courts have indicated the ability of a corporation to obtain a loan from an outside lending institution lends credence to the authenticity of a stockholder loan arrangement.[3] An arms length transaction with a lending institution shows that the relative degree of risk attributable to a stockholder loan is commensurate with a creditor arrangement. It is just within the last few years that this criterion has

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[1] _Tomlinson v. The 1661 Corporation, supra_ at 60.

[2] _Gooding Amusement Company, supra_ at 69.

[3] _Montclair, Inc. v. Commissioner_, 318 F. 2d 40 (5th Cir. 1963).

been used by the courts. This factor provides the courts with an objective standard which is evidence that a stockholder loan has the relative degree of risk appropriate to a creditor status.

Throughout the whole period of this study intent of the parties to a transaction has been considered in determining whether a security represented indebtedness or equity. The intent of the parties has been determined by the use of the criteria discussed above and evidence outside the contract. It appears that the courts in the early years determined intent by the formal aspects of the instrument itself and the subjective intent of the parties to the transaction. Recent court opinions reveal the court's emphasis on the substance of a shareholder-creditor arrangement and what can reasonably and objectively be inferred by the acts of the parties involved. An example of this substantive approach was cited in a very recent case.[1]

Each of the criteria reviewed above have been important in debt-equity determinations. The courts have been consistent in stating that each case must be judged on the facts presented and that no one factor is conclusive in determining whether a security represents indebtedness or equity. Stockholders in a closely held corporation planning the use of stockholder debt in their financial structure

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[1] United States v. Snyder Brothers Company, 367 F. 2d 980 (5th Cir. 1966).

should review the criteria discussed above and plan the debt structure accordingly. There is no formula which insures stockholder-creditors that their loans will be interpreted by the courts as bona fide, but the greater the number of criteria established in the debtor-creditor arrangement the greater the probability that the courts will find that a genuine creditor relationship exists.

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